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The Federal Reserve Bank of Philadelphia is part of the Federal Reserve System—a System which includes twelve regional banks located around the nation as well as the Board of Governors in Washington. The Federal Reserve System was established by Congress in 1913 primarily to manage the nation's monetary affairs. Supporting functions include clearing checks, providing coin and currency to the banking system, acting as banker for the Federal government, supervising commercial banks, and enforcing consumer credit protection laws. In keeping with the Federal Reserve Act, the System is an agency of the Congress, independent administratively of the Executive Branch, and insulated from partisan political pressures. The Federal Reserve is self supporting and regularly makes payments to the United States Treasury from its operating surpluses.

COMMENTARY

Preserving Discretion in Economic Policy

By David P. Eastburn, President
Federal Reserve Bank of Philadelphia

One of the characteristics of these troubled times is a widespread distrust of government officials. I'm not thinking so much of the fact that public opinion polls show Congressmen to be at about the bottom of the list when it comes to peoples' feelings of trust. Rather, I am concerned with the dangerous implications of this attitude for the field in which I happen to work—economic policy.

First is the conviction of more and more people that the only way to get government spending under control is to force outright limitations. There is much argument about what form the limitations should take—balanced budget, some proportion of GNP, etc.—but underlying it all is disillusionment in the ability of government to keep its spending within reasonable bounds.

Second is the increasing popularity of the view that the only way to prevent wide swings in the creation of new money is to require the Federal Reserve to set a target rate of growth for the money supply and stick to it. The idea is identified with Professor Milton Friedman, who for years has been preaching not only that the money supply is a vital determinant of economic activity but also that the Federal Reserve has consistently mismanaged money, producing inflation by letting money grow too fast and recessions by cutting money growth too drastically. He concludes that because the Fed is not smart enough to fine tune the money supply, it had better stick to a fixed growth rate. More and more people agree.

Third is the increasing popularity of gold as a haven for worried investors. As inflation has rampaged and currencies have gyrated, the price of gold has skyrocketed. People of means, looking for a rock of certainty in a sea of uncertainty, have turned to art, diamonds, antiques, land, but above all, gold. They see it as a commodity that will withstand the follies of government officials. They may wish longingly for a return to the gold standard.

I view all this with misgiving, not just because it is evidence of poor performance by officials (and as one of these I react defensively) but, more importantly, because it would take us back to a world that did not work well. Granted, the one we have is not working well either, but we should be wary about turning back the clock in a desperate search for solidity.

The idea of imposing economic rules on government officials is an old one. The balanced budget is an old rule. Drawing an analogy with personal finance, it said that a government that spends beyond its means is irresponsible. But since Maynard Keynes came on the scene in the thirties, most thinking people have become persuaded that balanced budgets for governments can, at times, be *bad* policy. And so we gradually have gotten used to thinking that discretion, rather than a fixed rule, is a better way to handle government financing.

With Federal Reserve policy, similarly, early thinking was that certain fixed rules—the gold standard, and credit supplied according to the needs of trade—were better than discretion in managing money. Experience taught us otherwise and we now have discretionary monetary policy.

The gold standard is perhaps the oldest rule of all, a rule that necessity has long since jettisoned. Policymakers now manage their currencies by use of discretion.

So we find ourselves in a world of discretionary economic policy, exercised by humans beset with impossible problems, with limited ability to solve them, and faced with a disillusioned public. I wish we public officials would do a better job; but I fear a reaction that would impose old rules on us, most of which have been found wanting, to meet today's problems. What is needed are better officials, more intelligent use of discretion, and more support from the public—not blind support, of course, but support that will encourage policymakers to evolve new ways to use discretion to meet new problems.

All this is easier to say, of course, than to do, but several beginning steps have already been taken. First is Congress's effort in recent years to come to grips with the budget process. This is promising, but it needs time and support to come fully into its own. It is a far more intelligent approach to fiscal discipline than arbitrary limitations. Second, in Federal Reserve policy, is the requirement of the Humphrey-Hawkins Act to specify annual growth rates for money and to account to Congress on results. Earlier requirements to target money growth proved too slippery; Humphrey-Hawkins promises more discipline. Third is the commendable effort to require officials to calculate the costs and benefits of their regulations, the famous success story being deregulation of airlines.

These are some specifics. Two general principles underlie all of them—accountability and performance. The public is only to blame if it fails to hold its officials accountable for their discretionary actions; to complain about "them" is a confession of failure to exercise proper surveillance. At the same time, an essential ingredient of credibility in discretionary policy is good performance. Strict accountability and good performance go together. In combination they should make it possible to exercise discretionary economic policy without resorting to arbitrary and inflexible rules.